Lee Burgess: Welcome back to the Law School Toolbox podcast. Today, we are doing another in our "Listen and Learn" series – this, on piercing the corporate veil. Your Law School Toolbox hosts are Alison Monahan and Lee Burgess, that's me. We're here to demystify the law school and early legal career experience, so you'll be the best law student and lawyer you can be. We're the co-creators of the Law School Toolbox, the Bar Exam Toolbox, and the career-related website CareerDicta. Alison also runs The Girl's Guide to Law School. If you enjoy the show, please leave a review or rating on your favorite listening app. And if you have any questions, don't hesitate to reach out to us. You can reach us via the contact form on LawSchoolToolBox.com, and we'd love to hear from you. And with that, let's get started.

Lee Burgess: Hello, and welcome back to the "Listen and Learn" series from the Law School Toolbox podcast! Today we are going to be talking about piercing the corporate veil, which is a commonly-tested issue in Corporations and LLC essays. We'll mention the small difference between piercing corporate and LLC veils later on, but today's podcast is going to focus on corporations.

Lee Burgess: So, what is a corporate veil anyway? In the eyes of the law, the corporation is an entity separate and apart from its owners. As a result, the owners of a corporation are generally not personally liable for the liabilities and obligations of the corporation. This separation between the corporation and its owners is known as the "corporate veil", and its protection from personal liability is one of the main benefits of starting a corporation.

Lee Burgess: To illustrate, let's assume we have an entrepreneur named Mike the Mechanic who starts a corporation called Auto Repair, Inc. One of Auto Repair's employees negligently damages a customer's fancy car. The angry customer sues Auto Repair and wins, but Auto Repair doesn't have the money to fully cover the damage to the customer's car. If the customer tries to sue Mike personally in order to make up the difference, the customer will not be successful because the law presumes that Mike and Auto Repair are separate entities.

Lee Burgess: But that presumption is not set in stone. Under certain circumstances, a court may disregard Auto Repair's corporate form and hold Mike personally liable, therefore piercing Auto Repair's corporate veil. What are those circumstances, you ask? Let's look at the rule.

Lee Burgess: A court will pierce the corporate veil and hold the shareholders personally liable in the following situations: one, the corporation is acting as the alter ego of the shareholders; two, where the shareholders failed to follow corporate formalities; three, the corporation was inadequately capitalized at its inception to cover debts and prospective liabilities; or four, to prevent fraud.

Lee Burgess: Now, there's a lot to unpack here, so let's take these one by one using Mike and Auto Repair to illustrate. First, what does it mean for a corporation to act as its shareholders' alter ego? Basically, it means that there is little to no separation between the shareholders and the corporation. For example, let's say that Mike pays all of Auto Repair's bills from his personal bank account. Or let's say Mike often takes money from Auto Repair's register to pay for his family's groceries. In such circumstances, Mike is treating Auto Repair like an extension of himself instead of as a separate entity. In other words, Auto Repair is simply Mike's alter ego.

Lee Burgess: Next, what does it mean for shareholders to fail to follow corporate formalities? Corporate formalities are usually defined by state statute, but generally speaking, corporations are required to create bylaws, hold regular shareholder and board of director meetings, maintain accurate records, and maintain separate bank accounts. If Auto Repair fails to meet these requirements, Mike can be held personally liable.

Lee Burgess: Next, what does it mean for a corporation to be inadequately capitalized at its inception? This will always be a fact-specific inquiry and will depend on the nature of the business and its anticipated liabilities. For example, if Mike initially capitalizes Auto Repair with $1,000, while a typical shop of Auto Repair's size requires at least $50,000 to adequately function and pay its debts, a court will likely find that Repair was undercapitalized. But remember that it's the initial capitalization that matters. If Mike initially capitalizes Auto Repair with $50,000, but ultimately does a poor job managing the corporation, leaving it with only $1,000 by the time it's sued, a court would likely not pierce Auto Repair's corporate veil.

Lee Burgess: Finally, when would a court pierce the corporate veil to prevent fraud? This typically comes up when the corporation is nothing more than a sham, created for the sole purpose of defrauding creditors. For example, let's say Mike knows that he cannot meet his obligations under a certain contract. Intending to hide behind the corporate veil, Mike creates Auto Repair, assigns the contract to the corporation, and then causes the corporation to breach the contract. In such a situation, a court would likely not permit Mike to hide behind Auto Repair's corporate form.

Lee Burgess: Now that we've gone through the factors, let's take a minute to clarify who they apply to. While our Auto Repair example involved a corporation owned by an individual, the same factors are applied to hold a parent company liable for the acts of its subsidiary. That's because a parent corporation owns its subsidiary and has the same ability to control it as an individual owner would. In contrast, passive investors who do not participate in the business will not be held liable, even if the court pierces the corporate veil. While passive investors are still owners, they do not exert control over the corporation.

Lee Burgess: We're almost done with our rules. There are just a couple more things to keep in mind. First, a court is more likely to pierce the corporate veil for tort actions rather than contract disputes. That's because the law presumes that contracting parties have a greater opportunity to investigate the corporation's ability to meet its obligations than a tort victim. Second, even if a court does not pierce the veil, a person is always personally liable for their own torts, even when acting as an agent for a corporation or organization. So going back to our earlier example of the angry customer, if Mike had negligently damaged the customer's car instead of one of Auto Repair's employee's, Mike could be held personally liable for his own negligence, regardless of whether the court pierced Auto Repair's corporate veil.

Lee Burgess: Now that we've covered the rules, we're ready to move on to the fun stuff. But before we do, a quick word about this hypo. Whenever possible, we try to adapt the hypos to cover only the narrow issues we're talking about. But sometimes that can be difficult, where the same facts trigger multiple issues. Depending on where you are in your studies, you might notice that the hypo we're going to cover today also triggers issues of breach of fiduciary duty and direct vs. derivative suits. That should tell you something. Because all three issues can stem from the same improper conduct of a business owner, they are often tested together. So, keep that in mind as you practice working through essay questions.

Lee Burgess: Okay, let's get to our hypo. This one was adapted from the February 2017 California bar exam:

Lee Burgess: "Years ago, Alan incorporated Retail, Inc. He paid $100 for its stock and lent it $50,000. He elected himself and two family members to the Board of Directors, which in turn elected him as President and approved a ten-year lease for a store. He managed the store and was paid 10% of Retail's gross revenues as compensation. Subsequently, Barbara bought 20% of Retail's stock from Alan. Retail's board then approved a contract to buy 30% of the inventory of XYZ Co., a company owned by Alan. Subsequently, Alan began taking home some of Retail's inventory without paying for it. Retail had net profits in some years and net losses in others. It paid dividends in some years and not in others. In some years, Retail's board met three times a year; in others, it never met.

Lee Burgess: Recently, Retail ceased business. Its assets were limited to $5,000 in cash. Among the claims against Retail was one by Supplier, who was owed $10,000 for computer equipment. Another claim was Alan's, for the $50,000 that he had lent and had just become due. Supplier filed a lawsuit against Retail and Alan.

Lee Burgess: On what legal theories, if any, can Supplier reasonably seek to recover against Alan on its claim against Retail? Discuss."

Lee Burgess: Okay, the question specifically asks us about recovering against a shareholder for a claim against the company. Right away we should be thinking about veil piercing. As always, start off with a header – "Piercing the Corporate Veil" – and state the general rule. Next, when the rule contains a number of factors or elements, you should create sub-headers for each one. Doing so helps you stay organized and also helps orient the reader. So, let's go through the factors together.

Lee Burgess: The first factor asks us to consider whether Retail was Alan's alter ego. Here, we are told that Alan began taking home some of Retail's inventory without paying for it. The facts do not state whether Alan intended to return this inventory or to keep it, but it seems that he failed to keep Retail's assets separate from his own. So, this would weigh in favor of piercing Retail's corporate veil.

Lee Burgess: The second factor asks us to consider whether Retail's shareholders failed to observe corporate formalities. Here, we are told that in some years, Retail's board met three times a year; in others, it never met. We know that a board is required to hold regular meetings, so at a minimum, the board is not observing corporate formalities every year. This too would weigh in favor of piercing the corporate veil.

Lee Burgess: The third factor asks us to consider whether the corporation was inadequately capitalized at its inception to cover debts and prospective liabilities. Here, we know that Alan started Retail by paying $100 for its stock and lending it $50,000. There is no indication that Retail was a high-risk business, and it appears that this initial capitalization was sufficient for at least a few years of operations. This includes years in which the corporation had net profits, which by definition means that it was able to meet its liabilities during those years. Remember that it's only the initial capitalization that matters, so the fact that Alan's management decisions likely contributed to Retail's lack of capital later on is irrelevant to the piercing analysis. Based on what we know, it doesn't seem like Retail was undercapitalized.

Lee Burgess: The fourth factor asks us to consider whether the court should pierce the corporate veil to prevent fraud. Here, there is no indication that Alan created Retail to defraud his creditors, so this factor weighs against piercing.

Lee Burgess: All told, we have two factors weighing in favor of piercing and two weighing against, so you could go either way. But given that Supplier's claim is a contract claim, and there is no clear evidence of a lack of separateness between Alan and Retail, a court would likely not pierce the corporate veil under these circumstances.

Lee Burgess: We hope that you found this hypo a helpful example of how to work through veil piercing issues. But before we finish up, we just need to quickly circle back to the difference between piercing corporate and LLC veils. The general rule is the same, with one small distinction: the failure to observe formalities is not a ground for piercing the LLC veil. Now, if you ever need to know California law, it's important to know that this difference is a little narrower. Specifically, California law provides that failure to hold meetings of members or managers, or the failure to observe formalities for such meetings, may not be considered a factor in piercing the LLC veil, unless the LLC's articles of organization or operating agreement expressly require the holdings of such meetings. So that's it. Other than that one distinction in California, you should approach veil piercing questions the same way whether you're dealing with corporations or LLCs. If you are in a different jurisdiction, make sure you check your state-specific rules if necessary.

Lee Burgess: And with that, we're all done for today. If you enjoyed this episode of the Law School Toolbox podcast, please take a second to leave a review and rating on your favorite listening app. We'd really appreciate it. And be sure to subscribe so you don't miss anything. If you have any questions or comments, please don't hesitate to reach out to myself or Alison at lee@lawschooltoolbox.com or alison@lawschooltoolbox.com. Or you can always contact us via our website contact form at LawSchoolToolBox.com. Thanks for listening, and we'll talk soon!

RESOURCES:

"Listen and Learn" series
California Bar Examination – Essay Questions and Selected Answers, February 2017
Examples & Explanations: Corporations, by Alan R. Palmiter
Podcast Episode 272: Listen and Learn – The Statute of Frauds (Contract Law)
Corporations 101 – A Quick Look at Upperclassmen Courses